

Prepared Testimony of

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on

China's Regulations on Software Procurement

Before the

Committee on Government Reform

U.S. House of Representatives

At a Hearing Entitled:

**“Domestic Source Restrictions Threaten Free Trade:
What is the Federal Government Doing to Ensure a Level
Playing Field?”**

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PREPARED STATEMENT OF MARK BOHANNON

Mr. Chairman, members of the Committee, I appreciate the opportunity to testify today on the Chinese government's regulation of software procurement.

I am Mark Bohannon, General Counsel & Senior Vice President of the Software & Information Industry Association (SIIA), the principal trade association of the software and digital content industry. Our more than 600 members produce world-class, innovative software products and information services for the business, consumer, educational and government markets, and range in size from many small and medium enterprises to many of the larger, well-known brands.

Through our leadership in the US Information Technology Office (USITO), the leading voice of the American information technology industry in Beijing which we helped create in the mid-1990's,¹ we have closely watched the enactment of China's new Government Procurement Law, the development of the regulations (known as "Implementing Rules") specifically addressing the procurement of software, and the overall efforts of the Chinese government to promote an indigenous software industry.

This hearing raises a number of relevant and appropriate questions: Are the efforts of the Chinese government to update and modernize its government procurement system likely, in the end, to impose restrictions on free trade? Are the domestic source restrictions in the Rules distorting free trade? Are they consistent with international norms? Do the "Rules" isolate the Chinese IT market from global commerce? And – perhaps most importantly – will the procurement regime prevent the local and national governments in China from getting the best available products at the most competitive price?

A careful examination of the software regulations, the details of which were released last month, indicates that the answers to these questions are far from acceptable.

Mr. Chairman, I submit for the record a detailed set of concerns and unanswered questions with the Rules that we submitted to the Chinese government on April 8th.² In the simplest of terms, the framework:

¹ **USITO** is an independent, not-for-profit, membership-based trade association, established in 1994 to act as the joint office in China for the U.S.-based high-tech industry. Currently, USITO's member, includes, in addition to more than 50 corporate leaders in the industry, the following parent organizations: the American Electronics Association (AeA), the Software and Information Industry Association (SIIA), the Telecommunications Industry Association (TIA), the Semiconductor Industry Association (SIA), the Information Technology Industry Council (ITI), and the Computer Systems Policy Project (CSPP).

² "Comments on the 'Implementation Rules for Government Software Procurement (draft) (March 31, 2005' ", contributed by the U.S. Information Technology Office (USITO), The Business Software Alliance (BSA), the American Chamber of Commerce in Beijing, the Telecommunications Industry Association, the U.S. Chamber of Commerce, and the Software & Information Industry Association (SIIA).

- Creates a two-tiered system that discriminates between “domestic” and “foreign” software vendors that will effectively prevent non-Chinese software companies from operating on an equal basis with “domestic” enterprises. Virtually no international software company could, based on our analysis, meet the requirements for producing “domestic software” under the Rule.
- Imposes onerous requirements on non-Chinese companies – including having to show potentially “hundreds of millions of USD” in accumulated investment in China, as well as specified percentages of foreign investment, research & development, outsourcing and taxes paid in China – simply to have their products *eligible* for consideration in government procurements.
- Discriminates against US, and all other non-Chinese, companies by demanding that a “waiver” must be given from the Ministry of Finance before any local or national government agency could purchase any product off the so-called “Preferred” list of non-Chinese software products and services. This duplicative requirement is imposed on foreign, but not domestic, companies. This time-consuming requirement alone is a market impediment that discourages Chinese government agencies from buying products that have already been deemed eligible for procurement after they have already met the discriminatory tests applied to foreign (non-Chinese) vendors.

If these Rules go into effect without substantial change, the result will be, in our view, demonstrable and detrimental restrictions on free trade. As it stands now, US software vendors enjoy generally favorable market access to the Chinese government procurement market. This is true despite the many real challenges that our industry faces in the Chinese market, including piracy of our products, lack of transparency in the adoption of government rules and inconsistent application of the “rule of law.” Our current market access is a recognition that US software vendors provide world-class, if not the best, products and services available in a globally competitive market for information technology products and services. The two-tiered system of “domestic” and “foreign” treatment found in the Rules appears to be intentionally designed to subvert this status quo.

In addition, the Rules as written stand in stark contrast to the international norms adopted by many of our other trading partners, including Japan and members of the European Union. The Rules describe novel government procurement practices in software that are unique to China and that bear little relation to the principles of the WTO Government Procurement Agreement (GPA), whose goal is to ensure non-discriminatory, pro-competitive, merit-based procurement of goods and services without technology-specific mandates. This is of great concern as the “Rules” appear to be in conflict with China’s commitment to become a member of the GPA, which today includes 36 parties.³

³ See “GOVERNMENT PROCUREMENT: THE PLURILATERAL AGREEMENT, Notification of national implementing legislation”, at http://www.wto.org/english/tratop_e/gproc_e/notnat_e.htm.

The “Rules” also stand in stark contrast to the stated goals of the Chinese government to bring its economy and its industries into the mainstream of global commerce. No country has attempted to isolate its software industry and software procurement market from the international IT marketplace to the degree set forth in the proposed “Rules.” As such, the proposed “Rules” represent a large step backward in the Chinese government’s efforts to integrate its domestic IT industries into the global economy.

Significantly, the procurement regime implemented by the Chinese government will prevent the local and national governments from getting the best available products at the most competitive price. The Chinese government’s original goal in updating its government procurement for software was to enable the government to use the best possible software at the best possible price, and to promote interoperability, thereby reducing redundant purchases. The U.S. IT industry has been very encouraging of the goal that China’s procurement regime should support the ambitious and effective e-government program being implemented in government agencies. The “Implementation Rules” severely impair the ability of the Chinese government and Chinese citizens to obtain the best possible products at the most competitive price, and instead promote the interests of certain domestic software companies.

It simply didn’t have to turn out this way. Over the course of several years, US industry and the US government have met enumerable times with experts at all levels of the Chinese government to get a better understanding of their goals, while sharing the experiences of US agencies in moving from government-specific requirements for procuring IT to a focus on “commercial-off-the-shelf” products and emphasis on “best value” in government purchases. Our discussions have emphasized the benefits of open, transparent and competitive procurement policies in meeting government needs. SIIA and USITO have hosted delegations of Chinese officials, providing them with the best expertise in this area. We have patiently explained in detail how our own system works, responding to misunderstandings about US preferences which are not, in fact, prohibitions on non-US companies. US industry has – working constructively with the leadership of the Department of Commerce, Department of State and the Office of the US Trade Representative – vigorously sought to engage with the Chinese government on a framework that achieved their goals while not discriminating against US companies and avoiding trade distorting measures, and how domestic source restrictions in their proposals threaten free trade.

Where do we go from here? It is incumbent on both the U.S. IT industry and the US government to continue to press for changes in the regulations on software so that US (and for that matter all non-Chinese) software providers are treated no less favorably than domestic ones. We must work with the Chinese government to ensure that the Government Procurement Law achieves what it set out to do originally – to bring China’s practices into the mainstream of international commerce. We commend the US government representatives, as well as many members of Congress, for their steadfast work on this issue. This commitment is important not just to our industry, but also

because the regulations on software are the first of what we expect to be a series of regulations affecting other industries and products.

At minimum, the Chinese must begin negotiations to join the WTO Agreement on Government Procurement, consistent with its WTO commitments, which were made more than four years ago. To date, no such discussions have taken place. As for changes in the regulations, non-Chinese software companies must be allowed to compete as “domestic” software companies if they meet non-discriminatory, minimal requirements that all companies must meet in order to operate in the Chinese market. This includes removing the requirement that, in order to be “domestic”, copyright registration must be held by a Chinese entity or person. The two-tiered scheme, where waivers must be obtained before any agency can procure “foreign” software, is simply unworkable and unacceptable.

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Background on the Software Regulations

The origins of the Software “Implementation Rules” issued in April emanate from two distinct policies adopted in China in recent years. The first is a new ***Government Procurement Law*** that went into effect at the beginning of 2004, following attempts over the years to modernize the way that the Chinese government at all levels purchases products and services. The Law is generally applicable to all products and services.

The Law, according to the Chinese government itself, is intended to establish a predictable and stable government procurement market that is administered scrupulously and efficiently, and requires that government procurement shall be carried out following the principles of openness and transparency, fair competition, equality, and accountability. Key points of China’s Government Procurement Law include a definition of government procurement and procurement parties, methods, procedures, contracts, complaints, supervision, verification, and legal obligations.

There are many regulations required to implement the Government Procurement Law including establishing the requirements for Article 10 which stipulates, “Government procurement shall purchase *domestic* goods, works and services...the definition of the above-mentioned ‘domestic goods, works and services’ are under the relevant regulations of the State Council.” [emphasis added]

The second pillar has been a concerted effort to promote ***an indigenous software industry*** through a series of policy statements that established goals and measures such as tax incentives, domestic procurement, and protection of intellectual property. For example, in the earliest statement on the subject, the State Council Informatization Office (SCITO) promulgated State Council Document No. 18 (SC18)⁴ which outlined incentives

⁴ “Some Policies to Develop the Integrated Circuit & Software Industry”, June 2000.

from 2001-2010 for the software industry, along with specific targets to reach by 2005 and 2010. In 2002, a supplementary Document No. 47 (SC47)⁵ outlined a short term supplementary policy to spur government agencies into implementing the provisions of SC18 that never became implemented. With regard to government procurement, the Action Plan in SC47 included the following provision:

Preferential Procurement of Local Software Products and Services

When drafting the government procurement of software products and services Catalogue and standards, government procurement should procure local software products and services. Using Finance funds to build informatization projects, the funds used for purchasing software products and services should in principle not be below 30% of the overall investment. Major national informatization projects should implement the bidding process system,⁶ project management system, and the implementing agency should have a quality certification. Encourage enterprises and other social institutions that during their own informatization construction to cooperate on development with software companies or to actively purchase local software products and services.

**Need for China to Accede to WTO
Government Procurement Agreement (GPA)**

The “Implementation Rules” that were released in April demonstrate that China must enter into negotiations to join the WTO’s Government Procurement Agreement (GPA). In December 2001, China joined the WTO and became an observer to the WTO’s Government Procurement Agreement (GPA) at the time of its accession. China pledged to join the GPA and committed to begin GPA negotiations. To date, no such negotiations have been initiated.

China’s announcement of its intention to join the GPA was a very positive development. Establishing a procurement environment in China that conforms to global norms will assist Chinese enterprises to develop and survive in the global government procurement market. An open government procurement market will encourage Chinese enterprises to enhance their competitive edge and to participate effectively alongside foreign companies.

**Summary of Concerns with
“Implementation Rules” for Software**

In a joint submission made on April 8th, several associations with member companies in the US IT industry identified a number of significant concerns and

⁵ "Action Plan for Invigorating Software Industry Development, 2002-2005", July 2002.

⁶ Ed. Note: This is a reference to China’s new Government Procurement Law.

outstanding questions about the Software procurement Rules. The major concerns are summarized below:

1. The Rules create a two-tiered system that discriminates between “domestic” and “foreign” software vendors that will effectively prevent non-Chinese software companies from operating on an equal basis with “domestic” enterprises.

Central to the Rules’ operation is a definition of “domestic software” and “domestic software service” that Chinese agencies are required to purchase. Thus, Chinese agencies will be able to purchase items that have been “certified” as “domestic” without restrictions. All other software products and services will be relegated to a second-class listing in the “Foreign Catalogue.”⁷ Our analysis leads us to conclude that the standards for being treated as “domestic” in the “Implementation Rules”, as proposed, would most likely exclude all international software products and services from government procurement.

To be “domestic” under the Rules, a software product must have its “final formulation\shaping up” in China, an artificial and workable concept. The Rules do not take into account the realities of today’s software development environment. Many of our members -- software companies of all sizes with customers around the world -- maintain research and development centers in China but centralize their manufacturing facilities where the CDs are pressed or their marketing operations overseas. If software is prepared and packaged overseas, but is co-developed by the vendor’s Chinese research and development center, the “Implementation Rules” would appear to still exclude such software from the preferred status of “domestic software” – and in many instances would exclude such software from the list of preferred “foreign” software. This result would create a tremendous disincentive to foreign direct investment in China’s software industry.

The Rules also require that 50% of a product’s development cost be incurred in China, a hurdle that is impossible for virtually all software companies – small as well as large enterprise -- to meet. First, the requirement ignores the emphasis many companies place on support, service, and upgrades. For products such as anti-virus software, the development cost may be trivial compared with the maintenance cost. Secondly, not all software companies capitalize development costs on a product basis; some companies lump together development costs for all products. Determining the development cost for a particular piece of software would ultimately depend upon a company’s own reporting, and the assessors could ultimately have no objective means for verifying the reports. The proportion of local content in any product may vary over time and is intrinsically difficult to measure when companies maintain cross-national development teams. Third, many software products and services that are on the market today are built from previously developed software or service components. It is unclear whether and how these prior, and significant, development costs would be treated under the “Rules.” Finally, because even companies that make large R&D and other investments in China

⁷ “Preferred Government Procurement Catalogue of Non-domestic Software Products” established in Article 18 of the “Implementation Rules”.

would often fail to satisfy the 50% threshold, the “Implementation Rules” would create a substantial disincentive to future foreign direct investment in China’s software industry.

The “Rules” also maintain a requirement (which US industry has consistently urged be removed) that the copyright belong to a Chinese natural person, legal person or other organization in the PRC as a condition for being “domestic.” First and foremost, registration of copyright as a precondition is specifically prohibited by the WTO TRIPs Agreement. Second, software companies that operate internationally would find it burdensome to deposit bits of code in different countries. That would force their units abroad to develop new software based on different foundations, and products gradually would become a hodge-podge of different code and standards. If this occurs only in China, China would run the risk of creating an isolated IT market for “domestic software.” The result would be that “domestic software” would be unsuitable for distribution or use in other countries and would work poorly with other software in the international market.

2. The “Rules” impose onerous requirements on non-Chinese companies simple to have their products *eligible* for consideration in government procurements.

US, and other Non-Chinese companies, must meet extraordinarily stringent (and in many cases impractical) requirements just to be included in the catalogue of “Foreign Software.” (As noted below in point 3, mere inclusion in the catalogue does not give non-Chinese software companies equal footing with domestic providers.)

To qualify for the “Foreign Software” catalogue, a supplier must show that it has (1) accumulated investment in China in the hundreds of millions of US dollars (the actual amount is unspecified at the moment) and that its annual investment in China is some fixed percentage of its annual turnover (again, the actual percentage is unspecified at the moment) for the last two years; (2) total R&D investment, outsourcing and taxes paid is a fixed percentage of annual turnover in China (again, actual percentage is unspecified) for the last two years; or (3) a software R&D center located in the China, is transferring “core software technology” to China, and annually training mid- and senior-level software personnel above some established number for the last two years. These requirements will have to be demonstrated on a yearly basis.⁸

These determinations will not be made by a Chinese government institution, but rather by a non-governmental organization, the Chinese Software Industry Association. We are shocked to see that a non-governmental entity is given the prominent role of making determinations of what companies and products fulfill the requirements. The Chinese Government Procurement Law regulates the government’s purchase of products, including software. This is a governmental function. The draft “Rules” do not allow an appeal of a negative decision by the association to the relevant Chinese ministries. While we have worked closely with the Chinese Software Industry Association and believe it

⁸ By contrast, a certification for a domestic software product is good for three (3) years.

makes important contributions to the development of a domestic software industry, placing them in this important role is not appropriate.

The problems with these requirements are numerous. For example, Chinese government procurement lists have been lists of products, not of companies. However, these requirements are about companies. In addition, it is not clear how the Rules will treat Companies affiliated by ownership links of 50% or more. Normal rules in this area would have them treated as a single company. Many corporations establish overseas subsidiaries to carry out their investment activities. A corporation that has invested in China should not be excluded simply because it used one or more subsidiaries as the vehicle to invest in China.

The threshold used for investment -- which assumes some number of “hundred million USD” -- is very high. This very high amount level would negatively impact many of our Associations’ members and prevent virtually all small- and medium-sized companies – and even many large companies -- from having their products in this “Foreign Catalogue.”⁹ The contributions of small- and medium-sized enterprises in the software industry are significant and the Rules should not to exclude these enterprises from the government procurement market.

Outsourcing of software to China should not be a qualification for inclusion in the list. We have made clear that none of our organizations can support a government policy in China that requires them to displace domestic jobs from their home countries in order to gain market access in another country.

3. The Rules discriminate against US, and all other non-Chinese, companies by demanding that a “waiver” must be given from the Ministry of Finance before any local or national government agency could purchase any product off the list of “Preferred” list of non-Chinese software products and services.

Even if the requirements above are met in order to be included in the “Foreign Catalogue”, the “Implementation Rules” provide that local and national agencies will still have to apply for a waiver to purchase items on this list. This would be extraordinarily time-consuming and would impose enormous costs, delays in implementation, and

⁹ The draft “Rules” discriminate in a number of ways between small- and medium-sized companies, on the one hand, and large companies on the other, by requiring a specific amount of accumulated investment in the aggregate, as the draft does in the first part of Article 19(1). This approach also favors equipment companies that may also make or distribute software over companies that only supply software since manufacturing is more capital-intensive. The same problem relates to the requirement for a specific number of persons to be granted training in the aggregate, as the draft does in Article 19(3).

The effect of using aggregate numbers will be to decrease competition in the Chinese market among the foreign companies, squeezing out small- and mid-size companies. This may result in higher prices and reduced services for Chinese buyers.

inefficiencies on agencies that are quite busy, as well as adversely affect the affected companies. The requirement to seek a waiver will, in and of itself, discourage procurement of non-Chinese software which is already on an approved list.

This duplicative requirement is a significant market access impediment for software companies that have products that are otherwise already eligible for procurement. Qualifying international software should be eligible for procurement without a waiver and on an equal basis to domestic software.

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Mr. Chairman, members of the Committee, we appreciate the opportunity to provide our views on these developments in the Chinese government procurement market. We will be glad to answer any questions that you may have.